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Silverhorn Perspective

US inflation and what it means for Asia

Keywords: Wage pressure, Housing shortage, Energy transition, Global supply chain, Monetary policy regime

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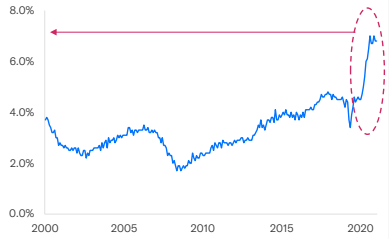
February 2022

On February 10, the US Bureau of Labour Statistics released the January consumer price index (CPI), which increased by 7.5% YoY. This is the fastest year-over-year change since 1982. While certain underlying drivers are transitory in nature (e.g. temporarily supply-constrained products such as autos) and some base effects will likely lead to lower CPI numbers towards summer, we believe that the US has entered a phase with structurally higher inflation. There are several reasons supporting our thesis: wage pressure, housing shortage, energy transition, global supply chain adjustments, and monetary policy regime.

1. **Wage pressure:** The US labour market is extremely tight as the unemployment rate is almost back at pre-pandemic lows and job openings are at multi-decade highs. The same is true for the percentage of firms reporting that they have difficulties in finding workers and the firms raising worker compensation. The tightness of the labour market is partially driven by cyclical and pandemic specific factors – which will soon abate as countries continue to roll back COVID-19 restrictions – and partially by a structural decline in labour force participation. James Bullard of the St. Louis Fed states, "Given the longer-run downward trend in labour force participation combined with retirees who have left the labour force and are unlikely to re-join it, it is not clear that we should expect labour force participation – and therefore employment – to return to pre-pandemic levels."[1] Should that turn out to be the case, wage inflation is likely here to stay.

[1] "Federal Reserve's Bullard: US jobs market is tighter than it looks" published in Financial Times on 1 June 2021

Job Openings Rate (JOLTS)

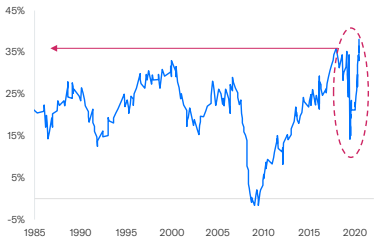


Source: Federal Reserve Bank of St. Louis

Percentage of NFIB Firms with Positions They Are Not Able to Fill Right Now

Source: National Federation of Independent Business

Net Percentage of NFIB Firms Raising Worker Compensation



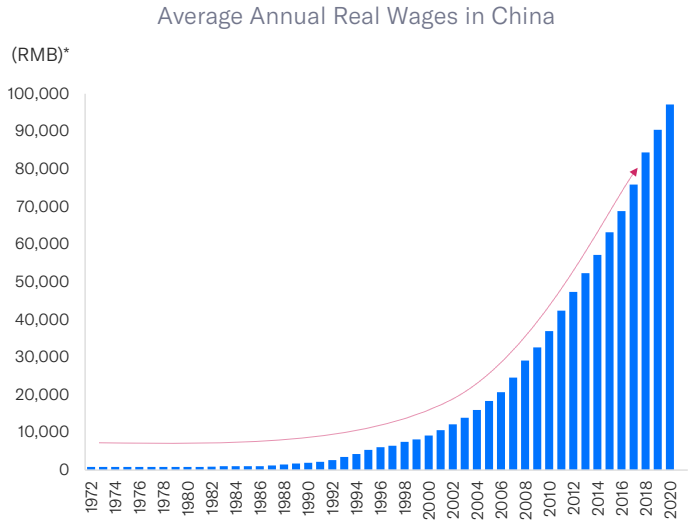
Source: National Federation of Independent Business

2. **Housing shortage**: US home prices are surging, and rental vacancy rates are at low levels last seen in the 1980s. The key driver behind this development is a housing shortage that has followed the Great Financial Crisis. The US Census Bureau found that 12.3mn American households were formed from January 2012 to June 2021, but just 7mn new single-family homes were built during that time. That supply-demand imbalance is rather structural as there is a severe construction labour shortage and demand for housing is boosted by strong income growth and historically low levels of debt service costs.

3. **Energy transition:** As we have written in our recent Annual Outlook Report*, the global energy transition is a highly complex endeavour. One of the key uncertainties around the transition is its effects on inflation. We believe two factors will drive up prices over a sustained period. First, over the last couple of years we have witnessed a significant slump in fossil fuel-related CapEx. The Economist estimates that from 2014 to 2021 investments into oil and gas exploration and production shrank from USD 800bn to around USD 400bn p.a., where it is expected to stay.[2] Therefore, in the short- to medium-term, a supply-demand mismatch is likely and will keep fossil fuel prices elevated. This could be positive for renewable energy as it will make it relatively more attractive. However, we believe that renewable energy technologies will experience some inflationary headwinds too because the demand for key production materials such as copper, nickel, cobalt, or lithium will dramatically outstrip supply (at current price levels). A recently published IMF working paper came to the conclusion that, "Metal prices would reach historical peaks for an unprecedented, sustained period in a net-zero emissions scenario. The total value of metals production would rise more than four-fold for the period 2021 to 2040, rivalling the total value of crude oil production."[3] The problem with sustained high energy prices is that it is a key input factor for a whole range of important economic activities (agriculture, materials, chemicals, transportation, etc). As a result, high energy prices have significant inflationary spill-over effects into the economy.

[2] "The age of fossil-fuel abundance is dead" published by The Economist on 4 October 2021
[3] "Energy Transition Metals" published by the International Monetary Fund on 12 October 2021
*If you would like to receive a copy of the 2022 Annual Outlook Report, The Age of Asia, please reach out to marketing@silverhorngroup.com.

4. **Global supply chain adjustments:** We do not believe in an "end of globalisation" scenario, but it is clear that we are going through a phase of global supply chain adjustments. There are different drivers of change here: First, and largely as a result of the experience during the pandemic, companies are moving toward more resilient supply chain models, where it is not all about "just-in-time" but also about "just-in-case". Second, this is to some extent also true on a country level, where geopolitical risk considerations are the driver. For example, the production of certain strategic products (pharmaceuticals and semiconductors) as well as the mining of important elements such as energy metals or rare earth will be brought home or, if that is not possible, to allied countries. Third, it became clear – even before the pandemic – that China will no longer serve as the provider of cheap labour, which was one of the key deflationary drivers over the last 30+ years. China's income level has dramatically increased during that time and technologically the country is moving up the value chain.



Source: National Bureau of Statistics in China

Overall, these supply chain adjustments will cost a lot of money and will make the system less capital efficient, albeit more resilient. Therefore, in the short- to medium-term we will likely see inflationary pressures from this adjustment process.

5. **Monetary policy regime:** In August 2020, the Fed announced a change in its approach to monetary policy relating to price stability. The new strategy is called flexible average inflation targeting (FAIT). Under this strategy, the Fed will seek inflation that averages 2% over a time frame that is not formally defined. This means that after long periods of low inflation, the Fed will not enact tighter monetary policy to prevent rates higher than 2%. In other words, this flexibility in the mandate allows the Fed to run accommodative monetary policy even when inflation numbers are high and the economy is booming. In the short-term, the ability to procrastinate rate hikes helps the Fed as meaningful rate hikes would likely not only kill the business cycle – which would be the historic norm – but would also be highly detrimental to capital markets (primarily stocks and bonds), which became used to abundant liquidity and low discount rates.

*Represents real wages after adjusting for inflation.

Therefore, the Fed is in an extremely difficult situation, where too much monetary tightening would kill the business cycle and induce large market corrections, and too little tightening creates the risk of losing control over inflation and potentially the inflation expectation anchor.
Should the Fed choose to tighten more and quicker than what markets currently factor in – which may well be the case – chances are that the Fed has to pivot to aggressive easing once again, as the economy and certainly markets will have a difficult time to cope with an environment of increasing interest rates. Moreover, structurally the US has entered a Monetary Policy 3 (MP3) regime where monetary policy is loosely coordinated with fiscal expansion. The objective is to create high nominal GDP growth, which is primarily achieved through high inflation. This is the only feasible way of managing, and eventually reducing, the accumulated debt pile and unfunded liabilities such as Social Security or Medicare.

Assessing the future path of inflation is notoriously difficult and it must be conducted with a probabilistic approach. There are a few obvious factors that could prove our thesis of structurally higher US inflation wrong: a technology-driven boost in productivity (which is the ultimate deflationary force), debt itself is a rather deflationary force, and a severe economic recession induced, for example, by too much Fed tightening.

Implications for Asia

First and foremost, we believe that Asia will not move into a high inflation regime. Three of the five above mentioned factors, including wage pressure, housing shortage, and monetary policy regime, are largely US-specific. Also, global supply chain adjustments will also have little effect on inflation in Asia, as globalisation and the accompanying global labour force arbitrage were primarily deflationary factors for the US and Europe. The only factor that will also increase inflationary pressures in Asia is the global energy transition. However, we should not forget that compared to the US, most Asian economies are still in the developing phase and have significant room for productivity improvements, which again are the ultimate deflationary forces. In terms of implications for investing in Asia, one must distinguish between the short- and the long-term. In the short-term, if high US inflation numbers lead to aggressive monetary tightening, we expect significant downside volatility in US capital markets. This would likely have ripple effects across global markets, including Asia, given the size and importance of US markets, and that global USD liquidity would shrink. However, a further correction in Asian equity and corporate bond markets would create an even more attractive opportunity set. As explained in our Annual Outlook Report*, we particularly like Chinese equities, ASEAN equities, and Asian credit with a focus on China's high yield property sector.

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Notable high-level exemplary factors that attract us to these markets:

1. **China equities:** The MSCI China Total Return Index is back at December 2017 levels and is currently trading at a 2022 P/E ratio of 10.7x. Sectors that will drive China's long-term growth have seen large corrections. For example, the MSCI China Healthcare Index is down close to 50% from its peak in June 2021 and lower than that pre-COVID. Even worse, the CSI Overseas China Internet Index has dropped by 55% since peaking in February 2021. At the same time, solid "old economy" stocks such as certain conglomerates or telecom companies trade remarkably cheaply at P/Es in the single digits while exhibiting dividend yields north of 5% and free cash flow yields well above 10%.

2. **ASEAN equities:** The MSCI ASEAN Total Return Index is trading at similar levels as in April 2013. In other words, there was close to zero return (in USD) for the last nine years despite solid economic growth. There are different reasons for this lousy performance, including local currency depreciation and a large index weight in financials. Given the significant underperformance of ASEAN compared to other markets, the region remains largely underallocated and overlooked by international investors, which is reflected in comparatively muted capital inflows. As a result, the region is trading at relatively cheap valuations (2022 P/E of 14.4x) despite being one of the most attractive secular growth stories, driven by favourable demographics, increasing labour productivity, and a growing share in global export markets.

3. **China high yield bonds:** The Chinese property market remains under severe pressure. The China Real Estate High Yield Total Return Index lost close to 50% of its value since May 2021. Investor panic and capitulation has created a rich, albeit complex opportunity set. The yield-to-maturity has reached an astonishing 65%. Roughly 28% and 19% of issuers are trading at stressed (<75c) and distressed levels (<50c) respectively. While more developers are likely to default amid strained liquidity conditions and weak contracted sales, stronger players will emerge as winners. We believe the market may find a floor once easing measures become more forceful to avert systemic and social risks. The relaxation of restrictions on escrow accounts was welcome news but further clarifications and action is required to restore confidence. For now, the market remains highly volatile, and a quick broad-based recovery appears unlikely.

In the long-term, higher US inflation and a potential loss of confidence in its monetary system will make Asia – the fastest growing region in the world – relatively more attractive in terms of its macro-economic environment, currency stability, and capital markets. High inflation and/or currency debasement (which often go hand-in-hand) is taxation without legislation as it destroys purchasing power, which is primarily an issue for poorer people. If you live from paycheck to paycheck and, all of a sudden, the price of your consumption basket, your healthcare bill, and housing costs start to increase faster than your salary, you have a serious problem. That is why high inflation – particularly food inflation, which is strongly linked to energy inflation – often leads to social and political upheaval.

While Fed policy makers have been determined to create higher inflation over the last couple of years (think ZIRP, QE, operation twist, and MP3) they may regret what they wished for. As inflation is partially a psychological phenomenon, it is hard to control once consumer behaviour has adapted to a higher inflation environment. As the late Bundesbank president Karl Otto Pohl famously said, "Inflation is like toothpaste. Once it's out, you can hardly get it back in again."

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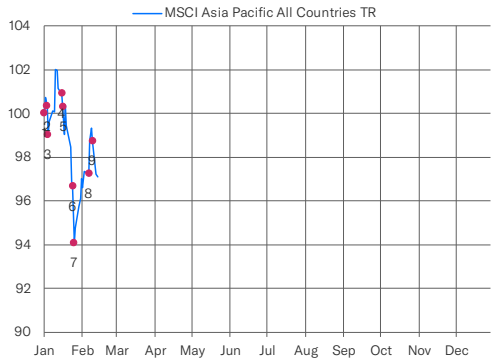
Monthly Market Dashboard

as of 15/2/2022



Major Events 2022

Nr.	Date	Event
1	Jan 03	USD10Y jumps as much as 13bps on 1st trading day of 2022
2	Jan 05	US logged 1mn new COVID cases in a single day
3	Jan 06	FOMC minutes show rate hike to be more aggressive than expected
4	Jan 17	China trade surplus hit record high among all countries in history
5	Jan 18	PBOC cut policy rate for the first time in two years, signal the beginning of an easing cycle
6	Jan 26	Russia - Ukraine tension
7	Jan 27	CSI300 enters technical bear market, down 20% from Feb 2021 peak
8	Feb 08	China failed to meet its purchase commitment under trade commitment
9	Feb 11	Inflation at 7.5%, highest in 4 decades, with cities running as high as 9.6%

Stock Market Returns (in %)

	YTD (LC)	YTD (USD)	QTD (USD)
S&P 500	-6.0	-6.0	-6.0
Euro Stoxx 50	-3.4	-3.6	-3.6
TOPIX	-3.9	-4.3	-4.3
KOSPI	-10.1	-10.6	-10.6
CSI 300	-6.9	-6.6	-6.6
MSCI China	-0.9	-1.0	-1.0
TAIEX	-1.5	-2.2	-2.2
Sensex	-0.1	-1.0	-1.0
SET	2.8	5.8	5.8
PSEi	2.6	2.2	2.2
VNI	-0.3	0.1	0.1
KLCI	2.0	1.6	1.6
STI	9.7	10.0	10.0
JCI	3.5	3.5	3.5
ASX 200	-3.1	-4.9	-4.9
NZX 50	-8.4	-11.3	-11.3

Bond Market Returns (in %)

	Yield (YTW)	YTD (LC)	QTD (LC)
Asia High Yield Bonds*	11.0	-4.2	-4.2
China High Yield Bonds	14.9	-9.7	-9.7
Asia IG Bonds*	3.2	-3.7	-3.7
China IG Bonds	3.5	0.6	0.6

* in USD unhedged

Exchange Rates

		Spot	YTD (%)	QTD (%)
USD Index		96.0	0.3	0.3
Gold		1854	1.3	1.3
Europe	EUR/USD	1.14	-0.1	-0.1
Australia	AUD/USD	0.72	-1.5	-1.5
Japan	USD/JPY	116	0.5	0.5
South Korea	USD/KRW	1200	0.9	0.9
China	USD/CNY	6.34	-0.3	-0.3
India	USD/INR	75.3	1.3	1.3
Singapore	USD/SGD	1.35	-0.2	-0.2

Sovereign Bond Returns (composites, in %)

	YTD (LC)	YTD (USD)	QTD (USD)
US	-3.8	-3.8	-3.8
Germany	-3.8	-4.1	-4.1
Japan	-1.5	-2.0	-2.0
Korea	-2.5	-3.1	-3.1
China	0.7	1.0	1.0
India	0.2	-0.8	-0.8
Singapore	-0.6	-0.4	-0.4
Indonesia	0.0	-0.2	-0.2
Australia	-4.3	-6.0	-6.0

Sovereign Bond Yields (10Y, in %)

Current	Low	Range (L12M)	High
2.0	1.2		2.0
0.3	-0.5		0.3
0.2	0.0		0.2
2.5	1.8		2.6
2.8	2.7		3.3
6.7	6.0		6.9
2.0	1.1		2.0
6.5	6.0		6.8
2.2	1.1		2.2

-2.0 0.0 2.0 4.0 6.0 8.0

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